In Defense of Bonds

My August column at Physician's Money Digest is entitled [In Defense of Bonds.]() This asset class is becoming less and less attractive to people the further we move into a stock bull market, when in reality, the opposite probably ought to be occurring!

> *We are now about seven and a half years into a bull market – not counting that very brief blip in 2011 that you probably didn't even notice. It is well-known that the further we go into a bull market, the more frequently we will hear the question, "Why not just invest 100% of my portfolio in stocks?" There is a well-known trend of threads about 100% stock portfolios on the popular Bogleheads.org investing forum, for instance. These threads are a daily occurrence during bull markets, then go away completely in bear markets. In addition, I am seeing more and more articles in the financial press and the blogosphere suggesting bonds are unnecessary and even harmful.*
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> *Now, I am no bonds apologist by any means. I have never held more than 25% of my portfolio in bonds of any kind. But to ignore this important asset class completely is a mistake, in my opinion, for many reasons that should at least be understood before someone decides on a 100% stock portfolio*

for the long run. Worldwide, approximately $82 trillion is invested in bonds, compared to just $55 trillion invested in stocks. Ignoring 60% of the investments in the world gives up a lot of diversification. Let's look at five of the arguments being put forth against bonds, one at a time, along with the reasons why it may not be as clear-cut as you might at first think.

1. Stocks will have higher returns

Stocks represent ownership in a company, while bonds represent a loan to a company, person, or government entity. When something goes bad with the borrower, the bondholders get their money back first and only if there is anything left over do stockholders get anything. Bondholders are promised their principal back plus a certain amount of interest periodically. Stockholders aren't promised anything. Thus, bonds are less risky than stocks. This includes not only "shallow risk," or volatility, that despite good long-term returns you may have low returns at any intermediate point, but also "deep risk," where permanent loss is possible. Stocks do not become less risky in the long run; they become riskier as there is a wider dispersal of returns and the likelihood of total loss becomes greater. Yes, that risk must be weighed against the risks of inflation and of your money not growing quickly enough to reach your goals, but to pretend that risk goes away if you can just hold on long enough is folly.

In addition, stocks have not historically always had higher returns than bonds. The experience of investors is often colored by that of investors in US stocks over the last 100 years. One of the best known examples is Japan, where the Nikkei stock index peaked at 38,915.87 on December 29th, 1989. How long did it take to get back to that point? Well, we don't know yet. After 27 years it is only at 16,497.36. Now, this is ignoring dividends, but also inflation, and is a good *demonstration of just how bad things can be. The experience of the US stock investor in the 20th century is rather unique in the history of the world. The future need not resemble the past. It is entirely possible for bond returns to outpace stock returns for 10, 20, 30, or even 50 or more years. When choosing an asset allocation, you are not only deciding what you think is most likely to happen, but also how sure you are that will happen. You must also consider the consequences of being wrong. I agree that stocks will probably outpace bonds during my investing career, but I'm not sure enough of that to put every investing dollar I have into stocks, especially given the consequences.*

Bonds diversify stocks. Not only do they moderate the volatility of stocks, but they are entirely different. There is low correlation between the returns of the two different types of assets. Often when stocks zig, bonds will zag. Even if your bonds are only returning 2% or 3%, that sure beats the -30% return that stocks may see in a nasty bear market.

In addition, many types of bonds have returns similar to those of stocks. In general, the longer the term and the less creditworthy the borrower, the better the return. Peer to peer loans and hard money lending can have returns of 7% to 12% or more, for instance. Junk bonds can also have quite high returns.

2. Stocks are more tax-efficient

Some have argued to go 100% stocks because stocks are more tax-efficient than bonds. Not only is this allowing the tax tail to wag the investment dog (the most tax-efficient investments are those that lose money), but it is not necessarily even true. Many investors have most or even all of their investments inside tax-protected retirement accounts, where tax-efficiency doesn't matter at all. Outside of retirement accounts, many stocks such as REITs and other companies with high yields are not particularly tax-

efficient. Meanwhile, some bonds can be very tax-efficient, such as savings bonds and municipal bonds.

3. I am young and have high risk tolerance

Investors in their 20s may argue that their youth and long-time horizon allows them to take the additional risk of a 100% equity portfolio. In reality, the typical 25-year-old has LESS capacity to take risk than an older investor for two reasons. First, his savings is not very large. It may not tide him over in the event of job loss or other personal financial catastrophe. Second, he has limited investing experience. An investor who started investing at any point in the last eight years has never actually invested through a bear market. All the risk tolerance questionnaires in the world pale in comparison to the best indicator of risk tolerance there is – your own behavior in a real, honest to goodness, severe bear market. Those who invested through the 2008 to 2009 Global Financial Crisis have a pretty good idea of their risk tolerance. They have an even better idea if they also invested through the 2000 to2002 Tech Meltdown. Reading and understanding financial history is important. Estimating your risk tolerance is important. But it is far better to dramatically underestimate your risk tolerance than to slightly overestimate it and end up selling low in a bear market.

The truth is that for a young investor the savings rate matters far more than the investing return. So what if you eke out an extra 1% or 2% on your $10,000 portfolio? You can make that up with a little moonlighting on the side or skipping a single nice restaurant meal. Don't lose the forest for the trees.

Young investors are also short-sighted in choosing a 100% equity portfolio. If they are truly risk tolerant and want to maximize their investing returns, why stop at 100%? Because it is a nice round number? It is not difficult to design a *portfolio with 110%, 150%, or even more exposure to equities using leverage and/or options. Benjamin Graham, the man Warren Buffett looked to as a mentor, argued that you should never have a portfolio with less than 25% bonds (75/25) or more than 75% bonds (25/75.) There is a lot of wisdom in that moderation.*

4. I am in it for the long run

Many investors not only assume that stocks will outperform in the long run, but that they can wait for the long run to spend their money. Job loss, divorce, disability, investment opportunities, career changes, family or personal illnesses, and death can all intervene and require some or all of your money in the short term. Experienced investors have learned that having some of your money outside the influence of the stock market can be very handy on occasion.

5. Bond yields are at historic lows

Some people argue for a 100% stock portfolio based on the current low expected returns of bonds. The best estimate of future bond returns is their current yield, at least for very high-quality bonds. For example, the Vanguard Intermediate Term Treasury Bond Fund currently yields just 1%. Corporate bonds of the same duration are yielding about 2.75%. These yields seem really low, and they are. However, inflation is also quite low. In the 1970s and 1980s inflation was often in the double digits. In the 1990s, it was mostly between 3% and 6%. In 2015 it was 0.12%. It hasn't even been 2% since 2012. So the real, after-inflation, yield of bonds is not nearly as bad as it might at first appear. Corporate bonds are currently besting inflation by around 2%. That isn't the 4% real yield you could get in 1990, but it isn't that different.

In addition, one must consider what stock returns are likely to be in an environment in which expected real returns for *bonds are low. When bond returns are unattractive, more investors move money into stocks, bidding up their price, and lowering future returns. In short, when expected bond returns are low, so are expected stock returns. The uneducated investor sees the low bond yields, but assumes that his stock returns will be equivalent to historical norms, which becomes increasingly unlikely as their price is bid up further and further.*

Choosing an asset allocation is a very personalized decision. The "100% stock portfolio" is always going to be controversial and perhaps may even be right for you, but be very careful choosing that allocation if you are relatively new to investing. The consequences of a slightly overaggressive portfolio are dramatically worse than a slightly under aggressive one.

Dr. Dahle is not an accountant, attorney, insurance agent, or financial advisor. He blogs as The White Coat Investor (link to http://whitecoatinvestor.com) and is the author of the best-selling The White Coat Investor: A Doctor's Guide to Personal Finance and Investing. (Link to http://www.amazon.com/The-White-Coat-Investor-Investing/dp/0991433106).

Read the other four reasons here, then come back and let me know what you thought.

Do you invest in 100% stocks? Why or why not? Comment below!